Supreme Court, U.S.
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No. 94-

IN THE
Supreme Court of the United States
OCTOBER TERM, 1994

CENTURY-NATIONAL INSURANCE COMPANY, *et al.*,
Petitioners,

v.

JOHN GARAMENDI,
Insurance Commissioner of California, *et al.*,
Respondents.

Petition for a Writ of Certiorari to the Supreme Court of California

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PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the cost-of-capital standard of *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), establishes a constitutional minimum for non-confiscatory rate regulation of a firm's regulated business.

PARTIES TO THE PROCEEDING

The petitioners in this case are: Century-National Insurance Company; Farmers Insurance Exchange, Truck Insurance Exchange, Fire Insurance Exchange, and Mid-Century Insurance Company (the FARMERS group); Federal Insurance Company, Vigilant Insurance Company, Sea Insurance Company, Northwestern Pacific Indemnity Company, Sun Insurance Office Limited, Alliance Assurance Company, Ltd., and Pacific Indemnity Company (the FEDERAL group); AVEMCO Insurance Company, Eastern Aviation and Marine Insurance Company, and National Insurance Underwriters (the AVEMCO group); Charter Oak Fire Insurance Company, Travelers Indemnity Company, Travelers Indemnity Company of Rhode Island, Travelers Indemnity Company of America, Phoenix Insurance Company, Travelers Indemnity Company of Illinois, and Bankers & Shippers Insurance Company of New York (the TRAVELERS group); Great American Insurance Company, Stonewall Insurance Company, and Transport Insurance Company (the GREAT AMERICAN group); General Accident Insurance Company, Pennsylvania General Insurance Company, and Camden Fire Insurance Company (the GENERAL ACCIDENT group); Home Insurance Company, Home Indemnity Company, Home Insurance Company of Indiana, and City Insurance Company (the HOME group); Zurich Insurance Company, American Zurich Insurance Company, Zurich American Insurance Company of Illinois, Empire Fire & Marine Insurance Company, Universal Underwriters Insurance Company, and American Guarantee and Liability Company (the ZURICH group).

The other parties to the consolidated cases in the court below included John Garamendi, Insurance Commissioner of California, and Voter Revolt, as well as 20th Century Insurance Company and 21st Century Casualty Company, and State Farm Mutual Automobile Insurance Company, State Farm Fire and Casualty Company, and State Farm

General Insurance Company. The two just-mentioned groups of insurers are the petitioners in a separate petition from the judgment below.

The remaining parties in the court below were: Hartford Steam Boiler Inspection & Insurance Company, Houston General Insurance Company, Balboa Insurance Company, Meritplan Insurance Company, Newport Insurance Company, Farmers Home Mutual Insurance Company, Western Home Insurance Company, American Continental Insurance Company, Sterling Casualty Insurance Company, Topa Insurance Company, Highlands Insurance Company, Highlands Underwriters Insurance Company, American Bonding Company, Continental Insurance Company, Boston Old Colony Insurance Company, Fidelity & Casualty Company of Newark, New Jersey, Fidelity & Casualty Company of New York, Fireman's Insurance Co. of Newark, New Jersey, Glens Falls Insurance Company, Kansas City Fire & Marine Insurance Company, Mayflower Insurance Company, Ltd., Niagara Fire Insurance Company, Pacific Insurance Company, Allstate Insurance Company, Allstate Indemnity Company, Northbrook Property and Casualty Insurance Company, Northbrook Indemnity Company, Northbrook National Insurance Company, USAA Casualty Insurance Company, USAA General Indemnity Company, United Services Automobile Association, American Bankers Insurance Company of Florida, Sequola Insurance Company, National Chiropractic Mutual Insurance Company, Republic Mortgage Insurance Company, Old Republic Insurance Company, Heritage Indemnity Company, Montgomery Ward Insurance Company, Forum Insurance Company, Motors Insurance Corporation, MIC General Insurance Corporation, MIC Property & Casualty Insurance Corporation, CIM Insurance Corporation, National General Insurance Company, Preferred Risk Mutual Insurance Company, Mid-West Mutual Insurance Company, Government Employees Insurance Company, GEICO General Insurance Company, GEICO Indemnity Company, and Criterion Casualty Company.

RULE 29.1 STATEMENT

None of the petitioners has a subsidiary other than wholly owned ones. The parent companies of petitioners are as follows: the parent of Century-National is Kramer Wilson Company, Inc.; the parent of the FARMERS group of companies is Farmers Group, Inc., whose parent is B.A.T. Industries, p.l.c; the parent of the FEDERAL group of companies is CHUBB Corporation; the parent of the AVEMCO group of companies is AVEMCO Corporation; the parent of the TRAVELERS group of companies is The Travelers Inc.; the parent of the GREAT AMERICAN group of companies is American Financial Corp.; the parent of the GENERAL ACCIDENT group of companies is General Accident p.l.c.; the parent of the HOME group of companies is Home Holdings Inc.; and the parent of the ZURICH group of companies is Zurich Holding Company of America, Inc., whose parent is Zurich Insurance Company, Switzerland.

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Petition for a Writ of Certiorari to the Supreme Court of California

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PETITION FOR A WRIT OF CERTIORARI

Petitioners, who are numerous insurance companies doing business in California's insurance market, challenge the California Supreme Court's construction of the constitutional standards for confiscatory price regulation. Pursuant to an initiative enacted by the voters of California in 1988, which was modified by the California Supreme Court on confiscation grounds in 1989, the state Insurance Commissioner in 1991 and 1992 adopted a complex formula, incorporating generic industrywide determinations as to permitted rates of return, to establish the maximum rates that insurers were allowed to charge in various lines of insurance during the year ending November 1989. The result has been a series of orders providing for refunds of billions of dollars. In several consolidated suits, the California Supreme Court broadly upheld the Commissioner's approach as consistent with this Court's confiscation stand-

ards under the Takings Clause. Petitioners challenge the California Supreme Court's construction of those standards.

OPINIONS BELOW

The opinion of the California Supreme Court (Pet. App. 1a-135a) is reported at 8 Cal. 4th 216, 32 Cal. Rptr. 2d 807, and 878 P.2d 566.[1] The opinion of the Superior Court of California (Pet. App. 136a-213a) is not reported. The earlier opinion of the California Supreme Court is reported at 48 Cal. 3d 805, 258 Cal. Rptr. 161, and 771 P.2d 1247.

JURISDICTION

The judgment of the California Supreme Court (Pet. App. 1a) was entered on August 18, 1994. A timely petition for rehearing was denied on September 29, 1994. Pet. App. 214a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257.

CONSTITUTIONAL, STATUTORY, AND REGULATORY PROVISIONS INVOLVED

The case involves the Takings Clause of the Fifth Amendment, which states: "nor shall private property be taken for public use without just compensation." The case also involves two state-law enactments: Proposition 103, a voter-enacted initiative that made changes in the California Insurance Code; and regulations issued by the California Insurance Commissioner. Pertinent portions of these provisions are set out at Pet. App. 375a-399a.

STATEMENT

Although rate regulation typically is imposed to restrain the exercise of market power by monopolistic firms, the

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[1] A separate petition for a writ of certiorari from this decision is being filed by several other insurance companies who were parties to the case in the California Supreme Court. *20th Century Ins. Co. v. Garamendi*, No. 94-—— (filed Dec. 23, 1994). Rather than reprint the voluminous materials, we rely on the appendix to that petition, hereafter cited as "Pet. App."

State of California has in this case imposed stringent rate limits, and ordered substantial rate rollbacks, on a market with approximately 700 competitors. *See* Commissioner's Br. in Cal. S. Ct. at 5. The regulations apply formula-based, generic, industrywide standards to all firms, regardless of differences in the actual returns needed to compensate investors for the particular risks that they assumed. Yet, while agreeing that the permitted rates must be judged by the constitutional standards for confiscation, the California Supreme Court concluded that the constitutional standards do not entitle a regulated firm to earn its market-based cost of capital for its regulated lines of business.

A. Proposition 103 and the *Calfarm* Decision

On November 8, 1988, the voters of California enacted Proposition 103 to make fundamental changes in the regulation of 18 lines of insurance, including automobile, property, casualty, and earthquake insurance. Prior to Proposition 103, California had employed an "open competition" system of regulation. Pet. App. 2a. Under Proposition 103, insurers were immediately required not merely to freeze their November 1988 rates, but to roll back those rates to 80% of their level one year earlier (November 8, 1987). Beginning one year after the enactment of Proposition 103—that is, on November 7, 1989, the end of the 1988-89 "rollback year"—insurers could apply for rate increases under a new regulatory regime requiring prior approval of the state Insurance Commissioner. The Commissioner must decide, among other things, whether the insurer's rate is excessive, but he is specifically directed to ignore " 'the degree of competition' " in the insurance market in making that determination. *See id.* at 6a, 71a. A rate increase *during* the "rollback year" was permitted only if " 'an insurer is substantially threatened with insolvency.' " *Id.* at 5a.

The rate rollback was immediately challenged in state court on federal- and state-law grounds. In *Calfarm Ins. Co. v. Deukmejian*, 771 P.2d 1247 (1989), the California

Supreme Court held that, as drafted, the rollback requirement violated the Takings Clause. The court focused on the "threatened with insolvency" standard for relief from the general rule requiring rollbacks to 80% of 1987 rates. Expressly relying on the confiscation standard set forth in *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944), the California Supreme Court held that "a rate may be confiscatory even though it does not threaten the insurer's solvency." *Calfarm*, 771 P.2d at 1253 n.9, 1254.[2] The court also observed that the insolvency standard "refers to the financial position of the company as a whole, not merely to the regulated lines of insurance," so that an insurer that was solvent based on out-of-state business or lines of insurance outside Proposition 103's reach would be precluded from relief from the rollback. *Id.* at 1254 (footnote omitted).

The state supreme court thus declared that limiting relief from the rollback requirement to cases involving threats of insolvency was invalid under the Takings Clause. The court then held, however, that the insolvency standard was severable from the remainder of Proposition 103. It therefore held that the enactment could constitutionally be applied as long as the Commissioner, in implementing it, compelled no rates below the minimum constitutional level. *Id.* at 1256-57.

B. The Commissioner's Implementation of Proposition 103

The state Insurance Commissioner began implementing Proposition 103, as modified by *Calfarm*, by issuing regu-

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[2] The court quoted the following standard from *Hope*: "'[I]t is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. [Citation.] By that standard the return to the equity owner should be commensurate with returns on investment in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.'" 771 P.2d at 1253 n.9 (quoting *Hope*, 320 U.S. at 603).

lations and conducting lengthy hearings on certain issues generic to the numerous applications seeking relief from the rollback. *See* Pet. App. 144a. When the new Commissioner, respondent John Garamendi, took office in January 1991 as the first elected (not appointed) holder of the office, he repealed the initial regulations and adopted a new set of regulations establishing a complex formula to determine the premiums that insurers were permitted to have collected in the rollback year (November 1988-November 1989). *See id.* at 14a-19a, 146a. He also conducted new hearings and adopted certain industrywide figures for key components of the formula, including the permitted cost of capital for all insurers, certain "efficiency standards" for all insurers, and the permitted amounts of capital (the "leverage ratios," defined as the ratios of premiums to surplus needed to back up policies, varying from line to line). *Id.* at 158a-159a, 163a-164a. The Commissioner derived the permitted (minimally non-confiscatory) cost of capital—found to be 10 percent—through evidence of the returns earned by the numerous firms in the California insurance market in the years preceding the rollback year. *See id.* at 188a.

In October 1991, the Commissioner selected 20th Century Insurance Company as the first insurer subject to a company-specific determination of its constitutionally acceptable rollback obligation. The Commissioner initially ordered a refund of more than $85 million (plus interest) for the rollback year. Pet. App. 149a. After proceedings before an administrative law judge, the Commissioner's final order, issued in May 1992, compelled a refund of $78 million plus interest (*ibid.*)—on an actual profit for the year of $76 million (*id.* at 126a, 205a).

C. This Litigation

A number of cases brought by 20th Century and by numerous insurers subject to the Commissioner's decisions, including petitioners here, were consolidated in the Superior Court of California. The complaints raised a vari-

ety of challenges both to the specific rollback order applicable to 20th Century and to the Commissioner's regulations and generic determinations.[3] The Superior Court held that the Commissioner's regulations were invalid on state- and federal-law grounds. Pet. App. 136a-213a.

In particular, the Superior Court concluded that the formula adopted by the Commissioner resulted in confiscation in violation of the Takings Clause. The court held that, to meet the *Hope* standard recognized in *Calfarm*, the Commissioner must allow a rate "that produces a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital." Pet. App. 177a. The court found that the "unique" formula adopted by the Commissioner (*id.* at 184a), through its complex operation, "always produces a lower return than even 10%," which the Commissioner himself determined to be the constitutional minimum. *Id.* at 177a n.20; *see also id.* at 184a (formula "automatically and inherently produces a minimum permitted premium which unavoidably does not permit even the lower boundary generic reasonable rate of return of 10% determined by the Commissioner"); *id.* at 198a (formula "always produces less than the 10% lower boundary rate of return"). The court also held that, under the *Hope* confiscation standard, the generic 10% figure could not validly be applied to 20th Century. The court explained that 20th Century's evidence established at least a 20% rate of return for its particular business, with its particular risks, and that there was "no evidence . . . contradicting 20th Century's evidence." Pet. App. 202a.[4]

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[3] Petitioners here were among the "Hartford Steam Boiler" group of plaintiffs, led by the Hartford Steam Boiler Inspection and Insurance Co.

[4] "Although *Hope* does not preclude a generic determination of a rate of return, it does contemplate . . . a rate of return which considers the capital needs of the regulated enterprise. What is missing here is evidence tying in the 10% return as reasonable

D. The 1994 California Supreme Court Decision

The California Supreme Court, with five of the seven Justices new to the court since *Calfarm*, reversed. Pet. App. 128a-129a; *Calfarm*, 771 P.2d at 1249, 1270. The court at no point found that insurers in this multi-competitor market had market power enabling them to impose supracompetitive prices on consumers or to earn returns on their capital incommensurate with their varying risks. Indeed, the court twice noted Proposition 103's express prohibition on even considering "the degree of competition" in the insurance market (Pet. App. 6a, 71a) and accepted that this market falls "outside the monopoly or public utility setting" (*id.* at 72a). *See also id.* at 86a. The court likewise made no effort to explain, in basic mathematical terms, whether the Commissioner's complex formula did or did not lead to revenues for the regulated business sufficient to cover (a) operating expenses plus (b) a market return on invested capital (the *Hope* standard); indeed, the court nowhere questioned the Superior Court's findings that the formula all but automatically produces less than the 10% return the Commissioner himself found to be the bare minimum for confiscation purposes. Nevertheless, the California Supreme Court upheld the Commissioner's formula and its application.

At the heart of the court's decision was its rejection of the *Hope* cost-of-capital standard, relied on in *Calfarm* (*see* note 2, *supra*), as a constitutional minimum. Pet. App. 79a. Thus, while accepting that the cost of capital "for 20th Century was found to be at least 20 percent," the court squarely rejected the proposition "that a regulated firm is entitled to its cost of capital." *Id.* at 116a. It based this holding on a reading of this Court's decisions that it reverted to repeatedly in its opinion. *E.g.*, *id.* at 76a-85a, 112a-116a, 123a-124a. And it stated that it was "fundamental error" for the Superior Court to have

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for 20th Century. Based on the only evidence in the record, 10% is confiscatory as to 20th Century." *Id.*

relied on the *Hope* standard as its test for confiscation. *Id.* at 83a.

The California Supreme Court purported to rest its holding on prior decisions of this Court. Having first made a passing reference to the general permissibility of "formulaic ratemaking" (Pet. App. 77a), the court went on to read this Court's decisions as establishing that a regulatory body may deny investors their interest in a market-based return on capital in order to provide further relief to consumers (*id.* at 79a). The critical passage quotes the *Hope* standard providing for such a return and then reasons:

> It must be emphasized that the foregoing describes an interest that the producer may pursue and not a right that it can demand. That interest is "only one of the variables in the constitutional calculus of reasonableness." (*Permian Basin Area Rate Cases*, [390 U.S. 747, 769 (1968)]).[5]

Pet. App. 79a. Immediately thereafter, the California Supreme Court's opinion stresses that " 'regulation does not insure that the business shall produce net revenues' " and that "such a firm has no constitutional right even against a loss." *Ibid.*, quoting *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590 (1942), and citing *Market Street Ry. v. Railroad Comm'n*, 324 U.S. 548, 564 (1945). In the same vein, the opinion states that *Hope*

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[5] The court repeated precisely the same analysis, with the same excerpted quote from *Permian Basin*, a few pages later, stating that this was the "crucial" point, one that "deserves special emphasis" (Pet. App. 83a): the *Hope* standard of profit sufficient to attract capital at a cost commensurate with the particular firm's risk "is, of course, an interest that the producer may pursue. But it is not a right that it can demand. It is 'only one of the variables in the constitutional calculus of reasonableness.' " Pet. App. 84a (quoting *Permian Basin*). It repeated the point again at Pet. App. 85a-86a. *See* pages 15-17, *infra* (discussing quote).

itself allows regulation that provides only a "meager return." [6]

Based on that reading of this Court's decisions, the California Supreme Court held that, to establish confiscation, a regulated entity must make a showing of " 'deep financial hardship.' " Pet. App. 83a, quoting *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1181 n.3 (D.C. Cir. 1987) (en banc); *see* Pet. App. 81a. Although the court did not precisely define that test, it emphasized that, under its reading of *Hope*, "a regulated firm may claim that a rate is confiscatory only if the rate does not allow it to operate successfully." Pet. App. 82a; *see also id.* at 125a. And it declared that, even then, "the inability to operate successfully is a necessary—but not sufficient—condition of confiscation." *Id.* at 81a.[7] Finally, in explaining how its standards for confiscation should be applied, the California Supreme Court concluded that "confiscation is judged with an eye toward the regulated firm as an enterprise" (*id.* at 77a-78a): the analysis "depends in this context on the condition of the insurer as a whole—and not on the fortunes of any one or more of its lines[]" of business that are subject to regulation by California under Proposition 103. *Id.* at 99a; *see also id.* at 118a.

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[6] "The *Hope* court itself expressly held that '[r]ates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return . . . .' (*Power Comm'n v. Hope Gas Co., supra,* 320 U.S. at p. 605.)" Pet. App. 80a. The court repeated this truncated quote at Pet. App. 114a. *See* pages 17-19, *infra* (discussing quotes).

[7] Before the courts below, the Commissioner urged essentially that analysis (*see* Br. of Commissioner in Cal. S. Ct. at 58-61) and added that, while "it is not clear what showing is required to establish confiscation" (*id.* at 60), an individual regulated firm apparently may not complain of confiscation if the rate it is allowed permits it to recover "out-of-pocket costs" (Reply Br. of Commissioner in Cal. S. Ct. at 40).

The California Supreme Court therefore rejected the confiscation challenges to the Commissioner's formula, despite the undisturbed finding of the Superior Court that the formula all but automatically denies insurers even the generic industrywide rate of return (10 percent) that the Commissioner found constitutionally minimal. The California Supreme Court also rejected 20th Century's as-applied challenge, performing its own quick calculation of the profit that 20th Century would be left with for 1989 (starting from the actual profit of $76 million) after subtracting the $78 million refund but adding back in the excess federal income taxes that 20th Century would have saved if it had charged only the lower rates now allowed by the Commissioner. Pet. App. 126a. That method, by the Commissioner's own figures, produces less than an 8 percent return.[8]

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[8] The California Supreme Court miscalculated the result produced by its own method, arriving at an 11 percent return (which is still less than the undisputed 20% cost of capital of 20th Century). It added back to 20th Century's 1989 after-tax profit of $76 million the full $29 million in federal income taxes paid in that year (then subtracted the $78 million refund ordered, arriving at $27 million in profit, representing an 11% return on $243 million of surplus). Pet. App. 126a. But the Commissioner himself has recognized that, even with the lower rates approved by the Commissioner, 20th Century would still have owed roughly $8.5 million of the $29 million in federal income taxes it paid in 1989. The proper result (under the add-back principle used by the California Supreme Court), therefore, would be a profit of roughly $18.5 million ($76 million actual profit plus $20.5 million in recouped federal taxes, minus the $78 million refund), amounting to less than an 8 percent return. *See* State Farm Reply Br. in Superior Ct. at 4. The actual bottom line for 20th Century, in short, is a return significantly below the 10% figure the Commissioner deemed constitutionally necessary.

REASONS FOR GRANTING THE PETITION

The California Supreme Court has adopted a fundamentally erroneous view of federal constitutional standards for nonconfiscatory regulation of a firm's rates. First, without offering a definition of the supposedly lower constitutional floor, the court rejected the standard set forth in *Hope*, in favor of a standard of "deep financial hardship." Repeatedly noting that a regulated firm has no constitutional right to a profit at all, the court thus held that it was "fundamental error" to require, as the Superior Court had done, rates adequate to "produce[] a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital." Pet. App. 83a-84a. Second, the California Supreme Court's insistence that confiscation analysis must focus "on the condition of the insurer as a whole" (*id.* at 99a) is naturally read as meaning that regulated, in-State lines of business may be subjected to otherwise-confiscatory rates as long as the enterprise as a whole, including unregulated activities and out-of-State activities, is doing well enough. Both of these aspects of the decision below demand review.

In denying a constitutional entitlement to earn the *Hope* market-based return on regulated activities, the court below not only relied on a patent misreading of this Court's decisions but repudiated the standards widely accepted by other courts. Indeed, the court's new standard conflicts with the standards recognized by the earlier California Supreme Court's decision in *Calfarm* (*see* pages 3-4, *supra*) and by the Ninth Circuit's decision striking down a Nevada measure based directly on Proposition 103. *Guaranty Nat'l Ins. Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990).[9] And the California Supreme Court's

[9] The cases are legion that recognize *Hope*'s cost-of-capital standard as a constitutional minimum. *See, e.g., Tennessee Gas Pipeline Co. v. FERC*, 926 F.2d 1206, 1208 (D.C. Cir. 1991) ("utility investors must be allowed an opportunity to earn returns sufficient to 'attract capital'" (quoting *Hope*, 320 U.S. at 605)); *United Gas*

"enterprise as a whole" conclusion rests entirely on one decision of this Court, *Baltimore & O. R.R. v. United States*, 345 U.S. 146, 150 (1953), which does not support the extraordinary proposition that confiscation of regulated activities is permitted if the enterprise earns enough in unregulated activities to afford it. Any such principle, in fact, would be deeply incompatible with other decisions of this Court.

Not only is the decision below seriously wrong, but it carries with it enormous practical consequences. The legal standards announced by the California Supreme Court, if left unreviewed, could dramatically upset settled understandings (on which investors rely) in all forms of governmental ratemaking, most notably for the many public utilities regulated at the state and federal levels. And if California is permitted to impose confiscatory rates on multistate insurers, particularly if out-of-State resources are invoked to offset in-State deficiencies, the effects will unavoidably be felt in other States, creating an extraterri-

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Pipe Line Co. v. FERC, 618 F.2d 1127, 1133 (5th Cir. 1980), *cert. denied*, 450 U.S. 911 (1981) ("*Hope Natural Gas* requires that the allowed rate generate sufficient revenue for the capital costs of the business."); *Jersey Central, supra; In re Public Serv. Co. of New Hampshire*, 547 A.2d 269, 271 (N.H. 1988) (Souter, J.) ("a utility's threshold entitlement is to a rate of return equal to the cost of capital"); *South Central Bell Tel. Co. v. Louisiana Pub. Serv. Comm'n*, 594 So. 2d 357, 362 (La. 1992) (same); *Central Maine Power Co. v. PUC*, 163 A.2d 762, 769 (Me. 1960) (same); *Mountain States Tel. & Tel. Co. v. Department of Pub. Serv. Regulation*, 624 P.2d 481, 482-83 (Mont. 1981) (same); *Alabama Power Co. v. Alabama Pub. Serv. Comm'n*, 422 So. 2d 767, 773 (Ala. 1982) (same).

On the other hand, several state supreme courts have disclaimed *Hope* as a constitutional minimum, based on the same errors in construing this Court's precedents as the California Supreme Court made. *See Ohio Edison Co. v. PUC*, 589 N.E.2d 1292, 1299-1300 (Ohio 1992); *Kansas Gas & Elec. Co. v. State Corp. Comm'n*, 720 P.2d 1063, 1071 (Kan. 1986), *prob. jur. noted*, 479 U.S. 1082, *appeal dismissed*, 481 U.S. 1044 and 483 U.S. 1036 (1987); *Pennsylvania Elec. Co. v. Pennsylvania PUC*, 502 A.2d 130, 134 (Pa. 1985), *appeal dismissed*, 476 U.S. 1137 (1986).

torial impact of the sort this Court has often condemned. *See, e.g., Healy v. The Beer Institute, Inc.*, 491 U.S. 324, 336-37 (1989).

More immediately, the numerous insurers with rollback-year cases before the Commissioner (having awaited this "test case") will be governed by the standards announced in the decision. Already, based on the formula upheld by the court below, the Commissioner has issued refund orders for the rollback year in amounts totalling more than $2.75 billion. *See* "Prop. 103 Rollback Orders," *Los Angeles Times*, Nov. 23, 1994, p. D3 (1991 order totalling $1.57 billion; orders issued Nov. 21, 1994, totalling $1.25 billion).[10] The standards also will govern the Commissioner's exercise of authority in setting the rate limits applicable to years subsequent to the rollback year. Both as to outstanding and future rollback orders, and as to post-1989 proceedings, the legal standards set forth by the California Supreme Court will place tremendous pressure on insurers to compromise their otherwise-legitimate claims of constitutional right. These standards are demonstrably incorrect, and they should not be allowed to stand.

A. The *Hope* Cost-of-Capital Standard for Confiscatory Rate Regulation Is a Constitutional Minimum

This Court recently summarized the basic constitutional doctrine applicable to regulation of rates. *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989). "The guiding principle has been that the Constitution protects utilities from being limited to a charge for their property serving the public which is so 'unjust' as to be confiscatory." *Id.* at 307. The Court explained that, under the "fair value" rule of *Smyth v. Ames*, 169 U.S. 466 (1898), this requirement for many decades was applied to protect "the

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[10] Rollback orders have been issued to the following petitioners in the following (rounded off) amounts: $138 million (FEDERAL); $65 million (HOME); $30 million (TRAVELERS); $73 million (GREAT AMERICAN); $37 million (Century-National); $17 million (GENERAL ACCIDENT); and $43 million (ZURICH).

actual present value" of the firm's property at the time of regulation. 488 U.S. at 308-09. As the Court further noted, however, the decision in *Hope Natural Gas* established that the constitutional standard could properly be applied to the historical cost of the firm's property, *i.e.*, to the invested capital, rather than to its present market value. 488 U.S. at 310.

The standard laid down in *Hope* is straightforward: "[I]t is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. . . . By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." 320 U.S. at 603. Even since *Hope* was decided in 1944, this has been the accepted standard defining the basic, minimum constitutional entitlement.[11] This standard, of course, by its terms points to the *market* as the basis for determining the necessary return to investors commensurate with the risks they assume in investing in the particular company, *i.e.*, the cost of capital.[12] Since profits

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[11] *See Duquesne*, 488 U.S. at 310 (quoting *Hope*, 320 U.S. at 605: the Constitution is satisfied by "[r]ates which enable [a] company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risk assumed"); *id.* a 311-12 (finding "overall impact" of rate order "not constitutionally objectionable" where rates do not impede "ability to raise future capital" and are not "inadequate to compensate current equity holders for the risk associated with their investments"). *See also* note 9, *supra*.

[12] The California Supreme Court itself explained: "'Cost of capital' may be defined as the rate of return available in the marketplace on investments comparable in terms of risk and otherwise or, more practically, as the expected rate of return a hypothetical investor would require to take a position in *the firm in question*." Pet. App. 30a (emphasis added).

earned are what is left over to pay investors after paying operating expenses, the *Hope* standard simply provides for a firm to earn its expected market-based return considering the normal relation of risk and return (anything less will send capital to other businesses; anything more will exceed what is needed to attract capital in competition with other investments).[13]

The California Supreme Court, however, rejected this accepted understanding. Although it quoted the *Hope* standard, it declared that a market-based return on capital was simply an investor interest in the constitutional calculus, not a constitutional right, and that investors had no right to any profit whatsoever. It thus held that a firm is *not* entitled to its market-based return covering its cost of capital but, as part of a balancing process (taking into account the interests of consumers), could be compelled to accept some lower return, even a loss. As we discuss, each step by which the court reached this conclusion rests on a serious misunderstanding and misapplication of this Court's decisions.

1. The California Supreme Court's first fundamental error was its simple misreading of *Permian Basin* as holding that the investor interest in a return meeting the *Hope* standard may be set aside, as part of a regulatory balancing process, in order to accommodate consumer interests. The court made this error partly by misquotation. After setting out the *Hope* standard as defining the investor's interest, the California Supreme Court said: "That interest is 'only one of the variables in the constitutional calculus of reasonableness.'" Pet. App. 79a (quoting *Permian Basin*, 390 U.S. at 769); *id.* at 85a-86a. But what *Permian Basin* actually says is that "*in-*

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[13] The California Supreme Court and the Commissioner recognized that the market requires higher returns for firms with higher risks: they acknowledged, in the opinion and in the regulations applicable to years after the rollback year, that an insurer with less surplus carries a higher risk and for that reason is entitled to a higher cost of capital. *See* Pet. App. 38a, 101a-102a.

vestors' interests provide only one of the variables . . . ." 390 U.S. at 769 (emphasis added). Since the broad notion of "investors' interests" hardly stops at constitutional minima, but extends to any achievable level of profit, this Court's uncontroversial observation in *Permian Basin*, when quoted in full, plainly does *not* say that the specific, minimum investor interest in meeting the *Hope* standard is to be balanced against consumer interests.

The California Supreme Court also evidently confused a statutory point in *Hope* and *Permian Basin* with a constitutional point. *Hope* observes that the familiar "just and reasonable" standard applicable *under the Natural Gas Act* states a statutory upper bound on permissible rates, so that "[t]he rate-making process *under the Act*, *i.e.*, the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests." 320 U.S. at 603 (emphasis added). *Permian Basin* makes the same point about statutory protection of consumer interests, quoting the above sentence from *Hope* as defining "the broad zone of reasonableness permitted *by the Act*." 390 U.S. at 770 (emphasis added). But nothing in either *Hope* or *Permian Basin* says that the *constitutional floor* is anything other than the investor interest in a market-based return on capital described in *Hope*.

To the contrary, *Permian Basin* makes clear that the bottom of the statutory zone of reasonableness is the constitutional *Hope* standard and that investor and consumer interests may be balanced only *within* that zone. 390 U.S. at 770 ("the just and reasonable standard of the Natural Gas Act 'coincides' with the applicable constitutional standards," quoting *FPC v. Natural Gas Pipeline Co.*, 315 U.S. at 586); *id.* at 792. The D.C. Circuit articulated this well-accepted understanding of *Hope* as early as 1950, explaining that "the minimal requirements for protection of investors outlined in the *Hope* case" define the constitutionally mandated lower bound of the zone of reasonableness established by statutes like the Natural Gas Act, which "is bounded at one end by the investor

interest against confiscation and at the other by the consumer interest against exorbitant rates." *Washington Gas Light Co. v. Baker*, 188 F.2d 11, 15 (D.C. Cir. 1950) (per Bazelon, J.), *cert. denied*, 340 U.S. 952 (1951). *See Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d at 1177 (quoting this passage with approval).[14] The California Supreme Court simply misread *Permian Basin* (and *Hope*) as permitting downward departures from the *Hope* cost-of-capital standard.

2. In addition to (erroneously) reading *Permian Basin* as authority for balancing away investor interests in the minimal *Hope* standard, the California Supreme Court invoked this Court's precedents to support the proposition that, as a constitutional matter, a regulated firm is not entitled to any profit at all. In reaching this conclusion, the court relied on *Hope* itself, on *FPC v. Natural Gas Pipeline Co.*, and on *Market Street Ry.* Again, however, the California Supreme Court plainly misread each of those authorities, none of which undermines the constitutional right of a firm to earn its market-based return on capital.

With respect to *Hope*, the state supreme court asserted that *Hope* itself approved regulation that " 'might produce only a meager return . . . .' " Pet. App. 80a, 114a. The full quote, however, says that regulation "might produce only a meager return *on the so-called 'fair value' rate base*." 320 U.S. at 605 (emphasis added). The quoted sentence thus has nothing to do with a supposed relaxation of the "cost of capital" standard set forth elsewhere in *Hope*. It is instead part of the very different discussion

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[14] *Jersey Central*, approving the *Washington Gas Light* formulation, thus could not support the California Supreme Court's notion (Pet. App. 83a, 125a) that "deep financial hardship" sets a constitutional floor below what *Hope* requires. Indeed, the court in *Jersey Central* itself explained that what it meant was precisely "the sort of deep financial hardship *described in Hope*." 810 F.2d at 1181 n.3 (emphasis added). *Jersey Central*, in short, is not authority for a standard different from *Hope*.

rejecting the doctrine of *Smyth v. Ames*, which held that the base to which the standard must be applied is the present "fair value" of a firm's assets (rather than the invested capital, as *Hope* held to be permissible). *See Duquesne*, 488 U.S. at 308-10.

The California Supreme Court equally misread the Court's statement in *FPC v. Natural Gas Pipeline Co.* that "regulation does not insure that the business shall produce net revenues." 315 U.S. at 590, *quoted at* Pet. App. 79a. This Court did not say—and, quite obviously, would not say—that regulators may impose a loss on a firm by taking away the expected return that it earned, operating efficiently, in the market. The Court was merely observing that it is up to the firm to *earn* its profit in the market: it has no constitutional entitlement to be subsidized by government or to receive a noncompetitive return, whether based on market power or on inefficient operations. Thus, the Court explained that "the hazard that the property [of a firm] will not earn a profit remains on the company in the case of a regulated, as well as an unregulated business": government-set rates must be "sufficient, having in view the character of the business, to secure a fair return upon the rate base *provided the business is capable of earning it.*" 315 U.S. at 590 (emphasis added).

For essentially the same reason, the California Supreme Court was far off base in its interpretation of the ruling in *Market Street Ry.* that the Constitution does not guarantee a firm against a loss. *See* Pet. App. 79a. The Court in *Market Street Ry.* merely concluded that government is under no duty to save a firm from the losses it incurs in the marketplace on its own. The Court explained that a firm like the Market Street Railway Company, which could not otherwise sustain itself, could not demand a particular rate if it "has not succeeded in maintaining its service on a paying basis" *in the market*. 324 U.S. at 566. Because the firm could not earn a return on its capital in an unregulated market, it could not invoke the decisions,

including *Hope*, applicable to firms "whose economic situation would yield a permanent profit, denied or limited only by public regulation." 324 U.S. at 566.[15] The present case, of course, involves a government limitation of profits earned in a (well-functioning) market, so *Market Street Ry.* is entirely irrelevant to the issue presented.

3. The California Supreme Court's error in construing constitutional standards obviously was critical to its judgment. This Court, of course, reaffirmed in *Duquesne Light Co.* that the Constitution does not prescribe methodologies, but is satisfied as long as the end result of rate regulation is non-confiscatory. 488 U.S. at 314-16. But the very error made by the California Supreme Court was in the standard to be applied in assessing the constitutionality of the end result. This is not a case, therefore, in which criticism of the particular components of a regulator's method for setting rates can be deemed beside the point, with only the end result tested against constitutional guarantees. The standards for testing the end result are themselves at issue.

The court below, moreover, made clear that its pronouncements as to the meaning of the Takings Clause were central to its entire opinion. It stated the standards for determining confiscation again and again, as the "crucial" points (Pet. App. 83a), in rejecting the various arguments made by the insurers. *See* pages 7-9, *supra*. And the court said over and over, in rejecting aspects of the Superior Court's ruling, that it was the trial court's misunderstanding of confiscation standards that "fatally tainted" the trial court's decision. *E.g.*, Pet. App. 115a, 118a, 120a.

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[15] The Court added that Market Street Railway Company *could not* earn a return on the investors' capital in the free market: higher prices would simply drive away too many consumers. 324 U.S. at 565. In that circumstance, the investors' capital lacked even its face value (but had only salvage value), and the Constitution "cannot be applied to insure values or to restore values that have been lost by the operation of economic forces." *Id.* at 567.

The centrality of the court's rejection of the *Hope* cost-of-capital standard is further confirmed by the court's application of its new standard—in particular, by what is wholly missing from that application. As noted, the California Supreme Court studiously avoided (as Proposition 103 commanded) any finding about market dysfunction demonstrating returns incommensurate with the risks of particular firms in a competitive market (which would be implausible in a market with hundreds of competing firms). At least as striking in its absence is any disagreement by the California Supreme Court with the trial court's findings that the Commissioner's formula all but automatically produces less than even the 10% industry-wide rate of return that the Commissioner himself deemed the minimal non-confiscatory rate. *See* page 6, *supra*. Likewise, the California Supreme Court undertook no effort to explain how, if at all, the formula produces a result matching the *Hope* standard of operating expenses plus a market-based return on proper capital, even assuming the validity of various adjustments to the permitted expenses and capital. Under the California Supreme Court's standards, all of these matters were irrelevant to the constitutional inquiry.[16] Those standards are wrong and should be reviewed.

B. Confiscatory Limits on Regulated Lines of Business Cannot Be Justified By Overall Enterprise Profits

In denying that a regulated firm is entitled to earn its market-based return on its regulated activities, the California Supreme Court stated several times that confiscation standards must be applied to the insurance companies' entire businesses, rather than separately to the regulated lines of insurance. *See* Pet. App. 77a-78a, 99a, 118a. If that conclusion is applied according to its literal terms—

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[16] The court's cavalier miscalculation of 20th Century's attributed return for 1989 (*see* note 8, *supra*) additionally confirms that the court deemed that result immaterial under its interpretation of the proper constitutional standards.

and the Commissioner has not indicated that he reads it any other way—it would mean that there can be no confiscation in the State's regulation of the rates for particular regulated lines of business as long as no confiscatory return is being forced on the enterprise as a whole, including *out-of-State* and *unregulated* lines of business. That proposition is insupportable.

The sole authority cited by the California Supreme Court for this extraordinary doctrine—this Court's 1953 decision in *Baltimore & O. R.R. v. United States, supra*—does not support it. It is one thing to say, as *Baltimore & O. R.R.* did on its facts, that a regulator may decide how to group together various pieces of a *fully regulated* business in applying minimal standards for compensatory rates. 345 U.S. at 150 ("so long as rates as a whole afford railroads just compensation for their over-all services to the public the Due Process Clause should not be construed as a bar to the fixing of noncompensatory rates for carrying some commodities when the public interest is thereby served"). It is an entirely different matter to say that a regulator may insist on a confiscatory rate for the business under its authority because *other* business, *not* under its authority, generates enough profits to keep the firm as a whole sufficiently profitable. That remarkable proposition—nowhere found in *Baltimore & O. R.R.*—is equivalent to saying that confiscation is permissible if the victim is wealthy enough to afford it.

Any extension of *Baltimore & O. R.R.* to these lengths would be inconsistent with other decisions of this Court. In *Northern Pacific R.R. v. North Dakota*, 236 U.S. 585 (1915), for example, the Court ruled that "it would be no answer [to a challenge to a State's confiscatory rate for particular carriage] to say that the carrier obtains from its entire intrastate business a return as to the sufficiency of which in the aggregate it is not entitled to complain." *Id.* at 595-96 (citing earlier cases where "the adequacy of the receipts from [a firm's] entire business did not enter into the question"). *See also Norfolk & Western R.R. v.*

Conley, 236 U.S. 605, 608-09 (1915). The discussion of these authorities in *Baltimore & O. R.R.* (345 U.S. at 148-49) says almost nothing to clarify how far government may go in looking to the entire business, even the regulated parts in the aggregate, to justify confiscatory regulation of particular lines of business in isolation. And any expansive reading of *Baltimore & O. R.R.* would seem to run headlong into this Court's recent ruling that a State may not justify a taking of one parcel of land "in light of [the] total value of the taking claimant's other holdings in the vicinity." *Lucas v. South Carolina Coastal Council*, 112 S. Ct. 2886, 2894 n.7 (1992).

In short, the Constitution and this Court's precedents cannot reasonably be construed to entitle a State to impose confiscatory rates on regulated aspects of an enterprise simply because the enterprise is doing well enough elsewhere in its business. That principle would have a dramatic impact on many of petitioners, who sell insurance outside California and who sell insurance inside California in lines (*e.g.*, life insurance) not subject to Proposition 103. Unless the Commissioner makes clear that he does not read the California Supreme Court's opinion to establish such a principle, this Court should review and reverse this aspect of the decision as part of the question presented. A regulated firm should be held entitled to a non-confiscatory rate, based on its cost of capital, for its regulated business.

CONCLUSION

The petition for a writ of certiorari should be granted.

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